RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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April 22, 1981 **LETTER 807**

April 10, DJIA 1000.27; PTI 1453; A-D Ratio –16.22
April 16, DJIA 1005.85; PTI 1459; A-D Ratio –16.28

THE MARKET: On March 25 (see chart below) the D-J Industrial and Transportation Averages rose to JOINT new highs (Industrials to 1015.22). This constituted a Dow Theory re-confirmation of the primary bull trend. But almost immediately, the market turned ragged. A minor decline ensued, followed by a new rally. The rally took Transports to a record 446.59 on April 15, but Industrials lagged (the Industrials have, so far, refused to confirm new highs in the Transports).

To add to the confusion, on April 15 the D-J Utility Average slumped to 105.35, its lowest level in a year. On the same day the D-J 20-Bond Average (and few investors are aware of this) sank to its lowest level (60.79) in history. Veteran readers of these reports know that I consider a declining trend in BOTH utilities and bonds to be a negative for the stock market.

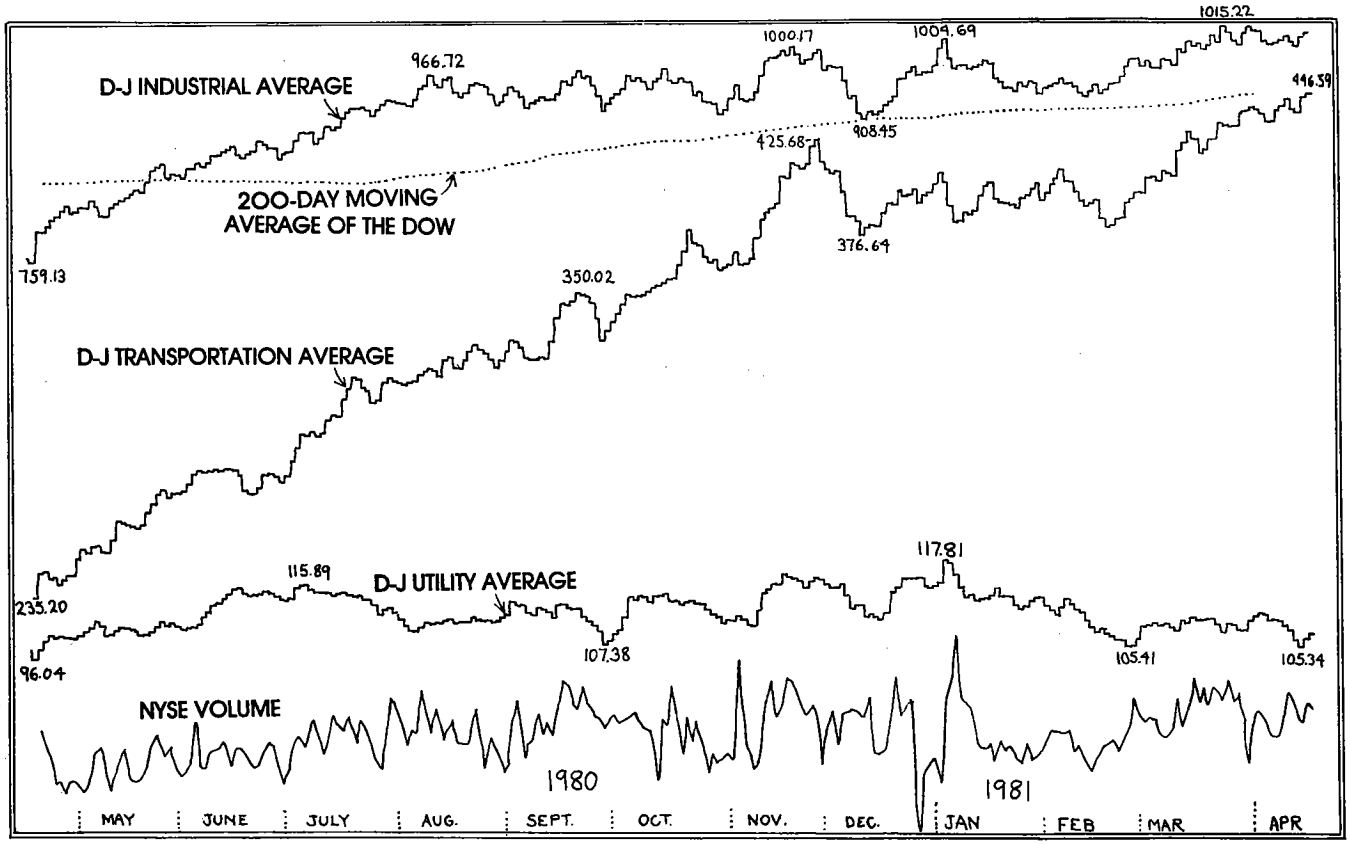
Question: Russell, would you review the whole market situation once again?
Answer: Yes, I feel that this is an opportune time to go over the whole picture, and here are my thoughts. The Dow Theory states that the current trend is still bullish. But this market has been sending out conflicting signals ever since last November, and I must admit that these signals bother me.

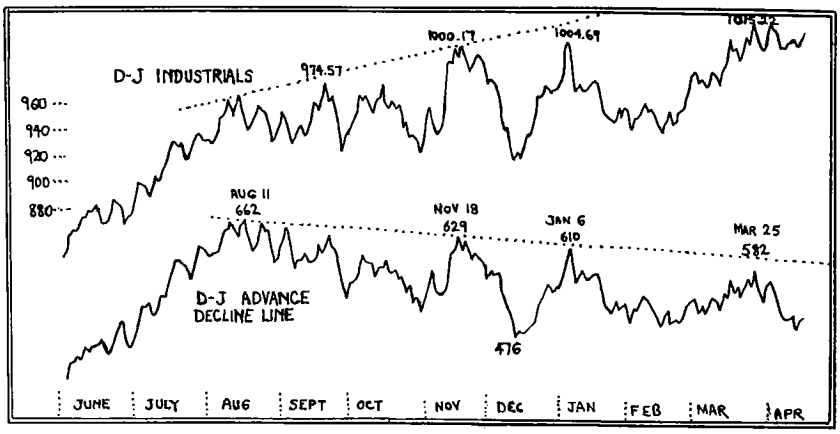
For instance, both D-J Averages pushed to highs as recently as March 25. But the broader Averages such as the Standard & Poor's 500 and the NYSE Index have yet to better their November highs (November 28 record high for the S&P was 140.52, the November 28 record high for the NYSE index was 81.02). The reluctance of these two important Averages to push to new highs is bothersome – it reflects a lag in the main mass of "other than Dow" issues.

By the same token, I'm bothered by the lagging A-D ratio on the NYSE, and this was discussed in detail in the last Letter. But

FRONT PAGE COMMENT: For the past three months most of Wall Street's "experts" have been predicting a collapse in the prime rate with accomanying lower interest rates. I've disagreed all along ("Stay in T-bills" was my advice). The T-bill rate hit a low of 12.52% on April 2 and has been pushing up since. T-bill rates (squeezed by the Government's insatiable demand for money and the general illiquidity in the economy) now appear ready to attack the 14% area. If the 91-day T-bill yields push above 14%, they will have reversed their major declining trendline. If that happens (i.e., a rise above 14%) my guess is that interest rates in general will move up towards the December highs (at which time T-bill yields were above 17%).

I continue to believe that somewhere along the line this nation's towering debt is going to trigger an "interest rate spike." Such a spike will set off a new bond market smash, at which time long-term Government bonds could go to yields of 15% or better (in my opinion). At that point this investor is going to load up with T-bonds. It will be (I think) one of the great investment plays of the decade.





perhaps the strangest thing about this market is the persistent, flagrant divergence between the Dow and its own advance-decline line. The Dow A-D line is followed by very few analysts, and the reason is that it takes a lot of work to compute this index (the Dow A-D line is a running total of the daily pluralities of advances and decline in the 30 Dow Industrial issues).

I have included my chart of the Dow and its A-D line on page 2. Note that since November there have been four successive peaks in the Dow A-D line, but each peak has been LOWER than the last. The obvious conclusion is that since November, fewer and fewer of the 30 Dow Industrial stocks have participated in the rallies. How long can this divergence go on? I really don't know, but it has already lasted longer than any other Dow divergence I've ever seen.

So as things stand, we have the strange case of the NYSE A-D ratio failing to confirm the Dow. And yet the Dow itself is showing internal weakness in that it's A-D line is lagging its price! In all, a strange and bothersome picture.

In the face of all this technical disparity my proprietary index, the PTI, has been plowing higher. On April 16 the PTI closed at a record high of 1459 (see chart), so that despite all, the PTI remains bullishly on the upside.

Question: The breadth of the market (NYSE) and the breadth in the Dow itself is poor, but despite this your PTI has been acting well, moving to high after high. How do you reconcile these conflicting actions?

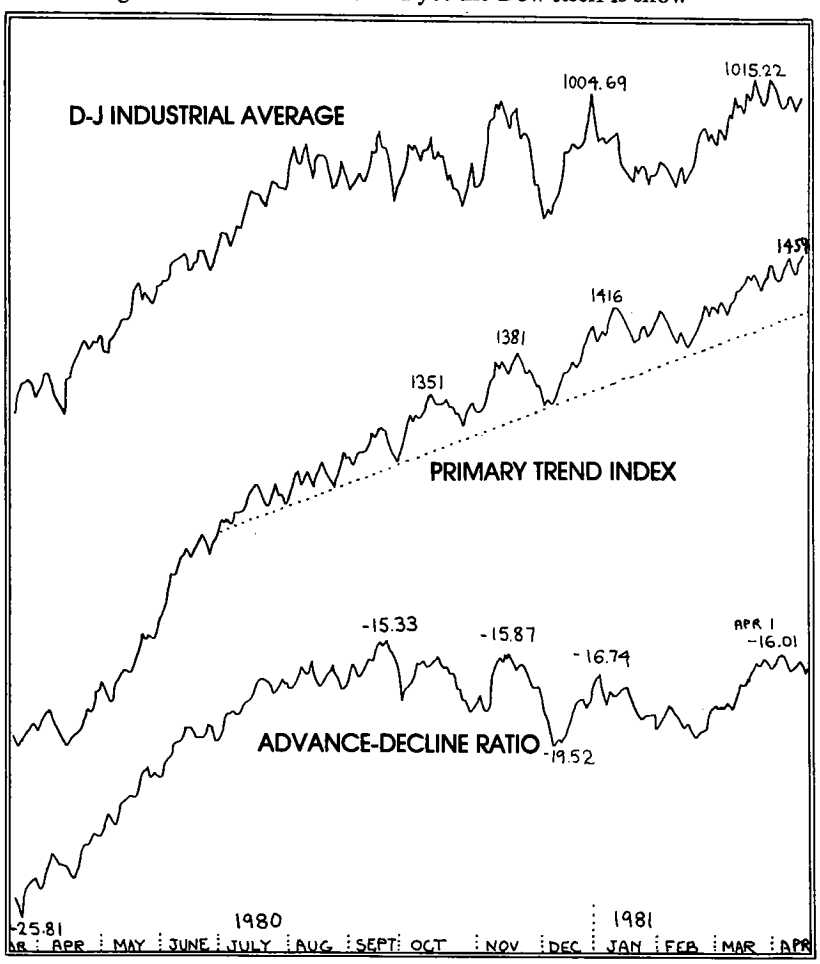
Answer: I've given this question a lot of thought. My answer is that the persistent divergence in the breadth indicators are saying that there is potential danger in this market. Whenever the mass of stocks (as measured by the A-D indices) fails to follow the Dow there is danger.

But as long as the PTI continues to hold above its rising trendline, it is safe to conclude that the potential market danger will be *held in abeyance.* However, I would venture to say that WHEN the PTI finally turns down and violates its long rising trendline, the odds are high that a bear market will begin.

Nevertheless, there's no sense jumping the gun on the PTI. This indicator has prevented us over and over again from turning prematurely bearish, and those who have followed the PTI have avoided any number of whipsaws.

Question: In other words, Russell, you are still placing great emphasis and credence on your PTI.

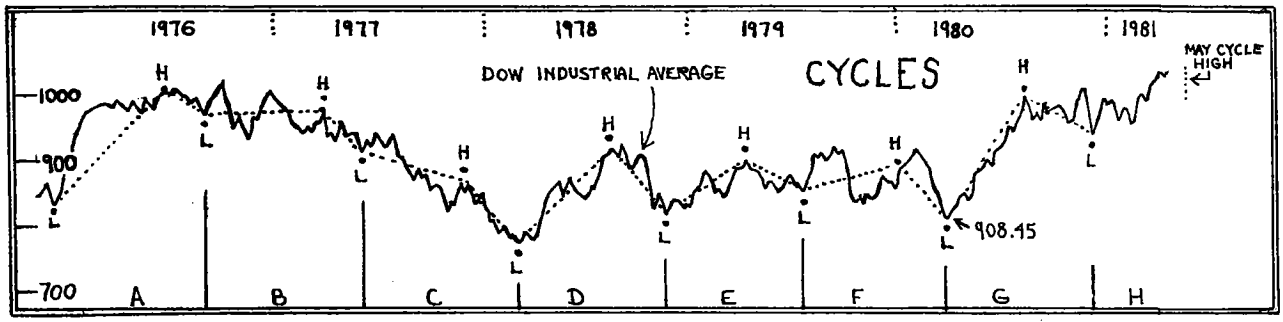
Anwer: Obviously, I am. As I've said many times, as long as the PTI traces out a rising trend, as long as it holds above its ascending trendline, this market will at worst hold firm, and at best push to new highs. It's impossible for the market to collapse while the PTI advances to consecutive new highs (as many of the bears have learned – to their sorrow). But somewhere ahead, and I don't know whether it will be early May or July or December, the PTI will turn down and begin tracing out a series of declining tops and bottoms. It will also break its rising trendline. When that happens, it will be "to the stormcellars" for readers of Dow Theory Letters.



Question: How does all this fit in with your studies of the 233-day cycle on the NYSE?

Answer: The market is made up of the thoughts and actions of millions of investors, and as such it is a living organism. Like all organisms, the market must breathe. I liken the market's breathing to inhalations (declines) and exhalations (rallies), and these arrive in the form of *rhythmatic* movements. Each completed movement (a full inhalation and exhalation) is known as a cycle. The cycle that I have identified and that I have found most useful is the 233-day cycle.

Each 233-day cycle is made up of two segments, a bull segment of roughly 144 days, and then a bear segment of about 89 days. Note on the page 3 chart that the low of the last cycle was recorded on December 11 at 908.45 on the Dow. That was followed by the current H cycle. The bull segment of the H cycle is due to peak in early-May (give or take a few weeks). And it could be that the bullish cyclical pressure is the force that



has been pushing up, or holding up, the Dow despite all the price/breadth divergences of recent months.

So I'll be most interested to see how this market acts as we now move into the period of the bull cycle peak, a period which should start in a few weeks or even less. In other words, between here and early May I'll be watching for a potential market top.

INVESTMENT POSITION: With the Dow yielding 5.5% and the D-J 20 Bond Average yielding 13.6%, the risk/reward in owning stocks is not attractive (regardless of the technical condition of the market). I personally am holding the bulk of my funds in 91-day T-bills which are now (with great safety) yielding near 14%. Limited holdings in no-load mutual funds are warranted as long as the Primary Trend Index (PTI) holds above its rising trendline.

Forget bonds; their time has not yet arrived. Gold insurance positions are all right, but if a gold base is forming (and I think it is), it's going to take more time.

WATERSHED: The year 1981 is, I believe, a watershed year, a year of historic change. The first change is subtle but it is this: *inflation has ceased being fun for borrowers.* No longer can a corporation borrow money at 10% for inventory and sit back while that inventory rises in value at the rate of 12% or 15% a year. No, the corporation must now borrow 14% to 15% and his inventory (maybe) rises at the rate of 10% to 13%.

For the individual the story is the same. A few years ago a person could take out a mortgage at 10% and buy a house that was appreciating at anywhere from 12% to 20% a year. No longer – the picnic has terminated. Now the buyer puts 20% down, adds a few points (we're up to 24%), then takes out a mortgage for 15.5% for the remainder – and he may not see any appreciation at all on his house (assuming he can even sell the house in today's market). So ... the inflation gravy-train is slowly grinding to a halt.

The next step – illiquidity and sluggish markets, with buyers (holding inflated merchandise) scouring the bushes for sellers. Enter the "creative financing" broker, the man who shows you how to "sell" your house while taking back most of the paper. Result; the banks are cut out and the seller ends up being his own bank. Conclusion: illiquidity and high interest rates are ending the guaranteed profit-through-inflation game for the individual and in most cases for the corporation.

So with the consumer neck-deep in frozen assets, the buying spree slows down. People start talking about the bankruptcies, the unemployment, the houses in the neighborhood that aren't moving. And the economy sinks into stagflation.

* *

The second very important phenomenon of 1981 is what I term "the market's taking command." Yes, I think this is the year when we will start to see the markets taking over from the politicians! The forces of debt and deficits (about which I have written for years) are now making the politicians stop, look – and wonder. No longer can a group of Congressmen or Senators propose bills for building this or that – for spending $4 billion here and erecting a new agency there. The fact is that America's money markets are slowly crumbling, the debts continue to explode, and the interest rates remain high. So the politicians have been dancing to a new tune, and the tune goes like this – "The public is fed up with inflation, they know that Federal deficits cause inflation, and they want it all to come to a halt."

But as I've said many times before, the politicians only move when (1) their backs are against the wall and their constituents are screaming. (2) Even then they only move enough to bring the constituents' screaming down to a dull murmur. We're at the second stage now – the politicians are trying to reduce the scream level. But they're not yet ready to deal with the fundamentals. The fact is that the Federal deficits are still going wild, the spending is still horrifying, and most of the sacred transfer programs have not been touched by the Reagan administration.

Next step – the markets will do the talking. On April 6 we saw one of the worst one-day busts in bond market history. Many long-term Government bonds were down over 2 points and long term T-bond rates went well over 13%. Many of the T-bonds smashed to historic lows.

The result of the continuing bond market collapse is now being seen in the financial condition of the banks, the insurance companies and the savings & loans. At market value, many of these institutions (taking into consideration their losses in bonds and mortgages) are under water – technically broke. In the S&L industry alone, the paper losses in mortgages are over $100 billion. On top of this, mortgage delinquencies are now running at the highest level in years (1.25% of the $500 billion in S&L mortgages are now delinquent).

Conclusion: The Federal deficits are not fooling the financial markets. Those markets are frightened, and they are sinking. There is little or no let-up in the rising level of mortgage rates, while bonds of all kinds are at or flirting with historic lows. This is rendering many businesses illiquid, even while long-term financing is literally drying up. America was built on long-term financing at low rates. It is now facing short-term financing at high rates. And the pressure of continuing Government deficits pushes the level of interest rates higher and higher.

NOTES & QUOTES: In Letter 805 I stated that Jim Dines was the only gold bull left. Well, here's a correction. My friends, Lawrence T. Patterson and Eliot Janeway have both been (and

still are) bullish on gold. They never faltered, and the record should show it. Papa Eliot's leaning has been to the S. African gold shares, while L.T. Patterson likes Krugerrands and gold shares. Sorry, fellows.

* *

My old hometown paper, the New York Times, has always been rather Keynesian and internationally minded. Therefore, it was with some interest that I read the following from an April 1st Times column (by Leonard Silk):

> **However, a new study, "Financial Disorder and International Banking" by Jack Guttentag and Richard Herring of the Wharton School of the University of Pennsylvania, concludes that "a crisis in international banking has become increasingly probable."**
>
> **The rapid growth of international banking activity, at a much faster rate than domestic activity, has exposed the banks to growing risks of borrower defaults and foreign-exchange losses. Light regulatory controls have allowed the banks doing huge amounts of business internationally to assume huge risks without challenge.**
>
> **"The most likely crisis scenario," say the Pennsylvania economists, "would begin with a development that substantially raises the expenses or reduces the revenues of one or more countries with heavy outstanding indebtedness to banks."**
>
> **Climbing interest rates, as well as oil bills, are increasingly burdening poor countries.**
>
> **Using floating-rate loan contracts in making Eurocurrency loans, Western banks have tried to protect themselves against interest-rate loss by shifting the risk to the borrower. But this, Mr. Guttentag and Mr. Herring warn, "could lead to a credit shock to lending banks, to a loss of confidence in such banks and to a run by creditors of such banks including other banks."**
>
> **United States banks have taken big risks in covering the deficits of the oil-importing countries of the third world. The latest lending-exposure survey of the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Comptroller of the Currency shows that, as of last June, American banks were owed $42.9 billion by nonoil-producing Latin American countries and $19.9 billion by nonoil-producing countries in Asia. The risks are compounded by the heavy lending done by West German, British, French and other foreign banks.**
>
> **Total foreign debts of the developing countries that do not produce oil have climbed to about $500 billion in the last decade, according to estimates by the Dresdner Bank of West Germany.**

* *

Many subscribers ask me what I'd do about Social Security. SS is a "chain letter." The maximum annual payroll tax for SS is now $1,975. It's expected to exceed $3,000 by 1985 and push well past $5,000 in 1990. What I'd do is scrap SS. I'd shut it down, and put most current SS recipients on a fixed carry-over payment which would be like "earned welfare." Those that did not need the payments would not get it. Then I'd start over again with a funded system which was based on actuarial tables. The current system is just a sham, a transfer from those who work to those who have retired. The only trouble is that the retired work force keeps growing and inflation keeps boosting the SS payments. The basics of SS are not valid; they don't work. No way of twisting are going to turn a lie into a truth. I say start over – and get it right!

What about those who would be "cheated" out of their just rewards? They would just have to be losers – like all of us who are cheated by inflation and other Government boondoggles. But we'd have to take it – in the interest of building an HONEST new U.S. – that works

* *

Latest entrant in the bankruptcy sweepstakes – the city of Detroit. A special committee has just reported to Mayor Young that unless city taxes are raised and municipal wages are cut, the city will be bankrupt by June 30. The committee said that Detroit (the nation's 6th largest city) will run up a deficit of $136 million for the fiscal year ending June 30. The auto fiasco – and then this?

* *

The rumor is that Secretary of State Haig will be lucky to last through the summer. Top candidates for his job are John Connally and former Treasury Secretary George Shultz. Complaints by close Reagan people :Haig is too liberal, has retained too many Carter advisors, and that he is unstable.

* *

How do sports fit in with a financial publication? Well, if you like the financial side of sports a book by David Harrop entitled "America's Paychecks, Who Makes What" presents these interesting statistics regarding which sport makes what. Conclusion: if you're going to buy a sports franchise (and some of my subscribers own them), make it a football franchise. This breakdown shows why!

Sport	*Attendance*	*Average Price*	*Approximate Ticket Income*
Baseball	40,800,000	$3.99	$163,200,000 *Television Income* $92,800,000 $256,000,000 total
Basketball	9,875,000	$6.78	*Approximate Ticket Income* $66,952,000 *Television Income* $74,000,000 $140,952,000 total
Football	16,057,000	$9.75	*Approximate Ticket Income* $156,555,000 *Television Income* $656,000,000 → $812,555,000 total
Hockey	8,526,000	$7.87	*Approximate Ticket Income* $67,099,000 total *Television Income* (Little network, small local income for individual teams.)

* *

Here are the latest figures from the Russell Debt-Watching Dept: Note that the Federal deficit is now $972 billion, only $28 billion from the "Big T." The Big T is ONE TRILLION, and it will represent one of the greatest shames in American history (I list the two American disasters of the 20th Century as (1) the Vietnam War, and (2) the trillion dollar deficit.

Government Finances

WASHINGTON (AP) – Here are figures on government spending and debt (last six digits are omitted). The government's fiscal year runs from Oct. 1 through Sept. 30.

Total public debt April 2	→ 972,079
Interest on public debt Feb	6,990
Interest fiscal year thru Feb	→ 37,119
Projected deficit fiscal 1981	54,894
Projected deficit fiscal 1982	44,961
Actual deficit fiscal 1980	58,990
Receipts fiscal year thru Feb	217,610
Receipts period last year	195,331
Outlays fiscal year thru Feb	273,624
Outlays period last year	233,543
Gold for Feb	11,156

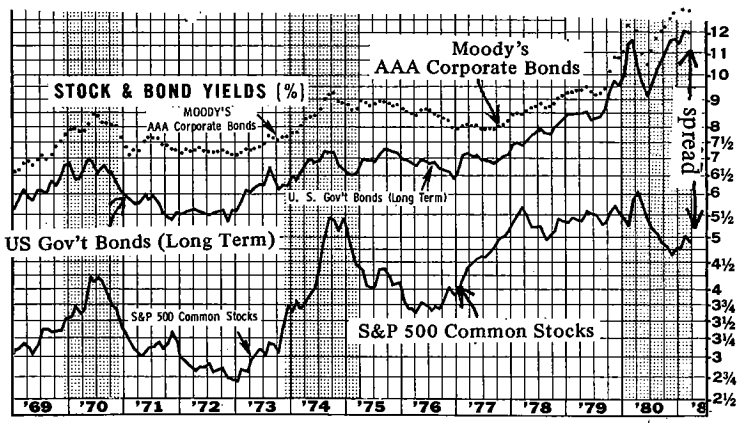
As I've often said, food is a big bargain in the US. Food now takes 16.4% of the American budget – compared with 25% in England, Germany and France and 27% in Japan. In S. Africa they spend 32% on food and even in Canada the figure is 21%. In the 1940's Americans spent 26% of their income on food. America is blessed with the best and cheapest and most food in the world – which may explain why obesity is an American problem.

* *

Modern Merchandising: Two weeks ago, in the face of a continuing severe sales slump, GM raised its auto prices 3.5%. The average price for a GM car is now $10,200! In 1946, by comparison, a Chevy cost $1,076. Last week incredibly, GM's President announced that the new GM compact cars were poorly made (this only days after the GM price increase!). My only explanation of GM President's devastating honesty : it was a slap at the work ethic of GM's workers (and the slap, not coincidentally) came at a time when GM (following Chrysler's example) wants wage concessions from its workers.

* *

Here's a chart showing the yield spread on common stocks and bonds. Right now, the spread is about 6% in favor of bonds, which is one whopping spread. If stocks are going to advance from here, we'll have to see new historic highs in the stock/bond yield spread.



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America's best-kept energy secret is out. It isn't going to be coal or nuclear or geothermal that is going to re-energize America, it's going to be natural gas. US reserves of natural gas have ballooned over the past few years, and reserve estimates keep climbing. And just wait until natural gas is de-controlled! Natural gas is clean burning and easy to use, and the trend has OPEC sweating oily tears.

* *

As stated in the last Letter, Russia isn't going into Poland because such a move would end Western aid to Poland (at which point, Russia would have to pay the bills). Poland is now unable to pay even the interest on its massive $24 billion in debts to the West. Poland owes $4.5 billion in interest this year (which we can forget about). What Poland wants now is $7.7 billion to tide it over until the end of 1983. The Russians, it is clear, know when to cool it!

* *

New York City co-op apartment prices have moved from high to higher to the realm of fantasy. Much of the buying has come from foreign sources, but certainly not all. The Beresford, a Central Park (West side) landmark recently offered rock singer Deborah Harry an apartment – price $1.8 million. An apartment at 1 E.End Ave. recently went on the market for a firm $2 million. A very good friend of mine bought an east side brownstone for $500, 000 in 1974. The building (and he doesn't want to sell it) would easily go for $5 million today. At the West Side San Remo building its spacious apartments go for $1 million or thereabouts, and the collective value of the entire building is estimated to be $100 million. The Beresford (the San Remo's sister, nearby building) sold in 1940 for $25, 000 cash over existing mortgages – and that gives you an idea of what's happened in NYC since World War II.

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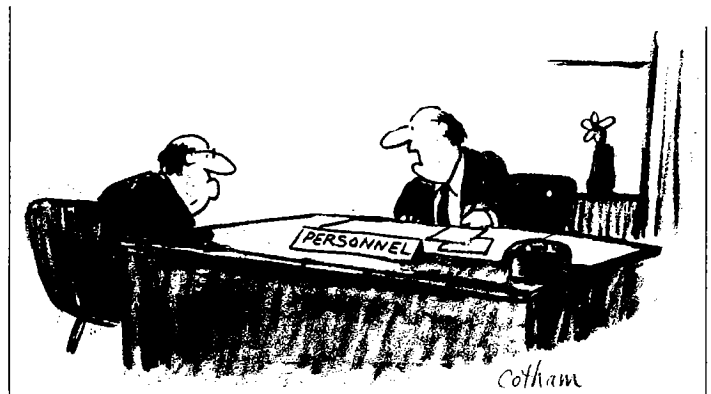
I showed this cartoon to four or five people. The response each time was, "Gad, that reminds me exactly of ....."



"Let me get this straight! All you've ever done is watch television?"

PENTHOUSE

GOLD: Gold hits its 1981 low on March (London AM fix) at 457. Gold then rallied to 547 in late-March, spurred on partly by the Polish crisis. More recently, gold slipped well below 500 again. As you can see on the daily chart, London gold, having rallied above its declining trendline, has now dropped back and made contact with that trendline again.

I believe gold is in the process of forming a major bottom. I'm guessing that the 457 low, if it's not THE low, is within 50 points of the low. The gold stock (gold shares) average, as seen on the chart, looks as though it has formed a double bottom. On the March-April decline, the shares held up better than the metal.

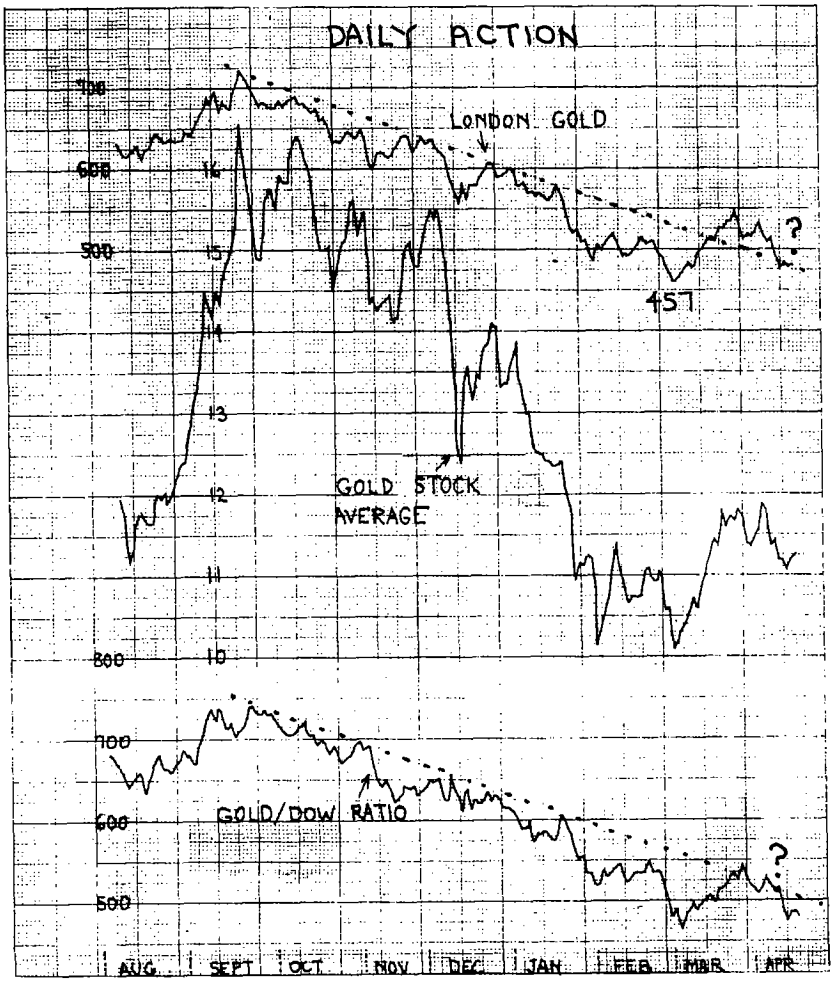
The ratio of gold to the Dow (see chart) broke above its descending trendline in late-March, then fell back again during April. But the ratio appears to want to bottom out, and if it does the inference is that gold is preparing to act better than the Dow.

The eyes of investors around the world are watching the US, the new Administration, and the on-going Congressional battle of the budget. On the minus side for gold is the pressure of rising interest rates. On the plus side for gold is the rising tide of US and world debt, and the possibility (dare I say probability) that most of the world's currencies will end up as antiques within the next 10 to 20 years.

The big question in my mind is this: inflation is not halting; it is not slowing down. By 1982 (the next Congressional elections) the American public is going to be fed up if real progress has not been made towards reducing inflation. Will Reagan and Volcker have the guts to put "The Big Squeeze" on the economy? If they do, we could see unprecedentedly high interest rates, disinflation, a smash in all areas, and then huge tax receipt fall-offs and monster Federal deficits. If, on the other hand, matters continue

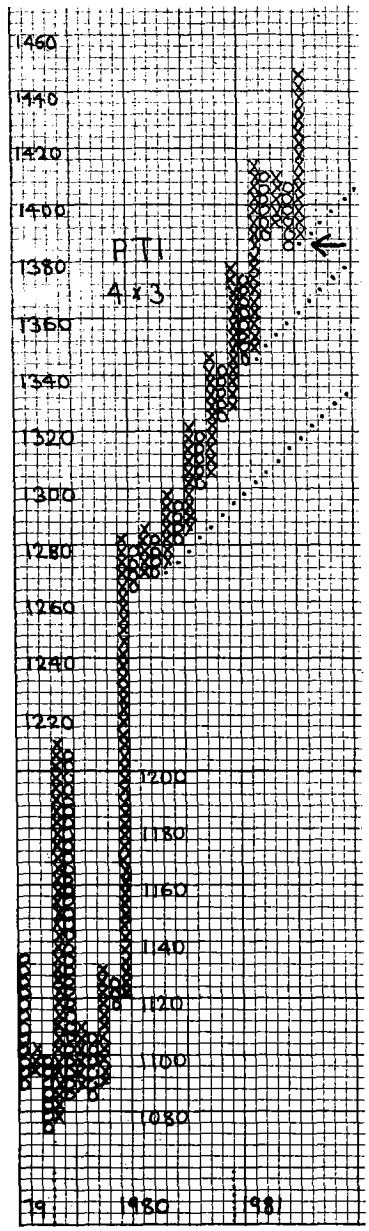
along as they are now, we will see stagflation, dislocations, and continued and probably still higher inflation. If that occurs, then I believe 457 will stand as the low for gold.

"But what happens, " you ask, "if Congress gives Reagan and Stockman essentially what they want?" And my answer is, "Not much. The budget cuts that Reagan is asking for will not balance the budget. And the tax cuts (if he gets them) will simply serve to keep inflation fired up. There's only one way to end inflation, and that's balance the budget and hold back the money supply. To put it gently, I don't see that happening – not the way things are going today! "



LATE NOTES: The market performance of 1981 is one of the most incredible I've ever seen. The broad composite Averages made their highs four months ago (Nov. 25) yet the Dow keeps stabbing over the 1000 level, falling back, then stabbing up again. It reminds me of an over-aged prize fighter who is battered and tired, yet savvy enough and courageous enough to keep hanging on. All this is measured by the PTI, which despite all problems and questions, holds doggedly above its long rising trendline.

I am including this point & figure chart of the PTI covering the period of 1979 to date. Each box on the chart equals 4 points on the PTI and only advances or declines of 12 or more points on the PTI are shown. The diagonal dotted lines depict areas of support. The power of the move since early 1980 is clearly shown. So far, all consolidation areas since 1980 have been resolved by fresh new upside breakouts. Until this changes, the underlying direction of this market is going to be up – it's as simple as that. Note: the arrow points to the first PTI sell-signal in 14 months, but the signal saw no follow-through, and it was quickly reversed to the upside when the PTI rallied to new highs.



LATE COMMENT: The latest (April 20) issue of Barron's carries an article entitled, "Box Score on Advisers." It's the story of the new Hulbert Financial Digest, a service which carries "box scores" of the various advisory services. It's a "fun" idea, and an interesting idea. But here's what I want to say. In 23 years in this business, I've never seen a case in which a reader followed an adviser over any great length of time and consistently made money on the advice of that adviser. I can help you, I can make you think, I can hopefully put you into a few good situations, but if you think I, or anybody else, can do all your investment thinking for you, forget it. It can't be done. As is true everywhere else, there's no free lunch in investing. It takes your sweat and your hard work, and ALL advisory services should be used simply as tools–not final answers.

Everybody hates uncertainty, and stock market investors are no exception. So amateurs and neophytes spend a lot of time looking for the advisory service with all the answers. If that's what you're looking for, I implore you to stop wasting your time. Instead, look for the service that can provide you with ideas, with information, with intelligent ways of thinking. And be skeptical of the service that implies that it can make you rich."Follow me, follow me" is the clarion call of the tout. "Do some thinking, do some work" is the call of the honest analyst.

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NEXT MAILING: May 6